

Internal Revenue Service
memorandum

CC:INTL-0618-89
Br5:JDorfman

date:

AUG 29 1989

to:

District Counsel
Austin, Texas

from:

Robert A. Katcher *RAC*
Chief, Branch 5
Associate Chief Counsel (International)

subject: Maquiladora Project--Mexican Debt/Equity Swaps

This is in response to your memo dated March 15, 1989, regarding the income tax consequences of Mexican debt/equity swaps. Our position regarding the taxation of gain or loss realized with respect to debt/equity swaps is clearly set forth in Rev. Rul. 87-124, 1987-2 C.B. 205.

In that ruling, Y, a U.S. corporation, purchased from a bank for \$60, U.S. dollar debt of a foreign country with a face amount of \$100. The bank, on behalf of Y, then exchanged the debt with the government of the foreign country for 900 units of the local currency (when the free market exchange rate was \$1 = 10 LCs) which was credited to the account of FX. FX then issued all its capital stock to Y. The 900 units of local currency were subject to restrictions as to their use. Rev. Rul. 87-124 holds that the transaction is treated as (1) a purchase of the debt from the bank by Y, (2) a subsequent exchange of the debt by Y with the government of the foreign country for 900 units of the restricted local currency, and (3) a contribution of the currency to FX in exchange for FX stock. The ruling further holds that Y has a gain on the exchange of the debt for the currency to the extent the fair market value of the currency exceeds \$60, Y's adjusted basis in the debt. The fair market value of the currency is determined by taking into account all the facts and circumstances of the exchange including the restrictions on the use of the currency. Y's basis in the currency is the \$60 plus the gain.

The analysis set forth in Rev. Rul. 87-124 is applicable to the debt/equity swaps entered into to finance the maquiladoras. It is important to know the facts of a particular debt/equity swap program but assuming the Mexican program is typical of most programs, the following analysis applies. A debt/equity swap entered into by a U.S. corporation with the Ministry of Finance of the Mexican government with respect to its wholly owned maquiladora is treated as (1) a purchase of the Mexican debt from a bank by the U.S. corporation, (2) a subsequent exchange of the debt

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by the U.S. corporation with the Ministry of Finance for restricted Mexican pesos, and (3) a contribution of the restricted pesos to the maquiladora for stock. The U.S. corporation realizes a gain on the exchange of the debt for the pesos to the extent the fair market value of the pesos exceeds the adjusted basis of the debt. The fair market value of the currency is a question of fact. The U.S. corporation's adjusted basis in the pesos is equal to such corporation's basis in the debt plus the gain recognized on the exchange. Since the basis of the pesos will generally equal their fair market value on the date they are transferred to the maquiladora, section 367 will not cause recognition of gain on the transfer of the pesos for stock of the maquiladora provided the fair market value of the stock equals the fair market value of the pesos.

If you have further questions regarding the application of Rev. Rul. 87-124 to debt/equity swaps entered into to finance maquiladoras, please don't hesitate to contact me or Jeff Dorfman at FTS 566-6284.

cc: Val J. Albright
Kim A. Palmerino